RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Nov. 4, 1998 **LETTER 1264**

FED ACTION: Lower rates and pump up the money supply; that's the Fed's answer to the world money squeeze, world deflation, over-production and the global fear of risk (see MZM section below).

Will it work? Will a surging US money supply serve to reverse a bear market and turn it into a bull market? Don't count on it. But note this -- bullish sentiment has been reviving. After the first down-leg in a bear market, there is almost always a recovery rally that looks "almost better than the real thing." It happened in 1930 after the 1929 crash, it happened in June through August of 1937 following the earlier 1937 smash, it happened during August to October 1973 following an earlier 1973 collapse, and it's happening now.

THE BEAR: The rapidity and heavy volume of the October rally has encouraged many investors. But what we've been seeing is typical bear market action. In a bear market the (upward) corrections tend to **be rapid and violent,** often recouping in a few weeks what it took many months to accomplish on the downside.

The underpinnings of the rally would have seemed impossible 10 years ago. I'm referring to the fact that the price/earnings ratio for the S&P 500 is a sky-high 27.5, while the yield on the S&P is a minuscule 1.5%. Yet, in the face of this extreme overvaluation, buyers have been rushing back into the market. And you have to ask yourself -- is this a picture of seasoned investors accumulating great values? Hardly, but with the bullish psychology and the cult of equities still very much in place, there remains an obsession to be fully invested in stocks.

As a result of the rally, I've received many calls asking, "Russell, has a new bull market arrived?" Answer: I sincerely doubt it. Try to envision this: The D-J Transports hit a bull market high of **3686.02** last April 16. Three months later, on July 17, the Dow recorded a bull market high of **9337.97.** The Transports refused to confirm the July 17 Dow high. From there the two Averages headed down. When, on August 4, both Averages smashed through their preceding reaction lows, a bear market was signaled.

As I see it, the two Averages (during the April through July period) were "telling us" that, according to Dow Theory, **the market was discounting the best that could be seen ahead.** If the best has been seen, then there is no where to go but down, down into a bear market. But neither Dow Theory nor any other theory can tell us **how** the market (and the economy) are going to go down or **how long** the process will take.

It could take a few weeks, a few months or a year before the bearish "verdict of the market" becomes reality. In the meantime, the Averages can do a lot of things -- they can rally, they can decline, they can meander, **a single** Average might approach, or even better, its bull market high. Major bull market tops can take time, and they can be extremely deceptive. Remember, we're talking about the top, the end, of the greatest bull market in history. It makes sense that a giant bull market with its upward momentum is not going to reverse in a day or a week, and it makes sense that the top is not going to be obvious; no bell is going to ring when the great bull falls to his knees and dies.

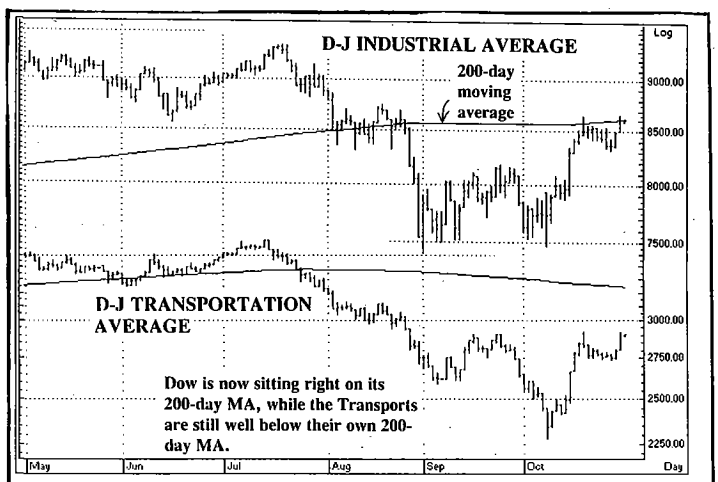
Oct. 23 DJIA 8452.04; PTI 5280; A-D Ratio +4.43
Oct. 30 DJIA 8592.10; PTI 5292; A-D Ratio +5.06
Dow Yield: 1.75%; Dow Price/Earnings: 23.1
Dow 144-day MA: 8404; Dow 34-day MA: 8253
Dow Times Book Value: 5.30; PTI 89-day MA: 5292
Percentage of Undervalued Blue-chips: 7%
Gold 34-day MA: 296

I'm asked, "Russell, what would it take to prove your bear market thesis wrong?" My answer is this -- if **both** Industrials and Transports rise to new highs above their April-July bull market highs, I will have been proved wrong. Could that happen? Is it possible that the two Averages could rise to new highs? I don't think it will happen. My instinct tells me that it won't happen. But yeah, it could happen. Remember, "The stock market can do anything."

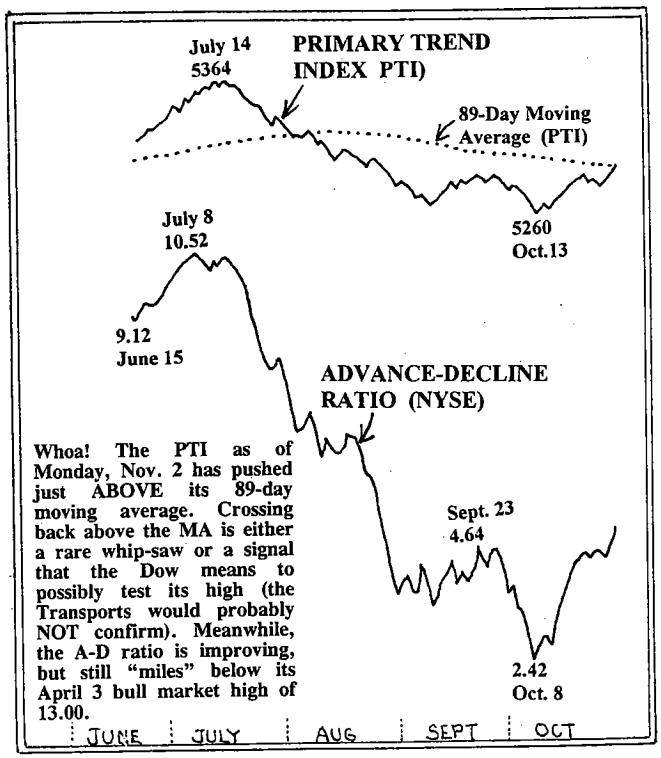
"OK, Russell, and what's all this volatility about? It's getting so we can't get a day with the Dow swinging up or down by less than 100 points."

My answer is that this is what you get when the greatest bull market in history is both blowing its top and simultaneously mortally wounded. There are violent differences of opinions at this juncture, frantic buyers, worried sellers, sudden huge program trades -- the result, wild and erratic markets. On top of this you've got 7,000 (or is it 9,000?) mutual fund managers all committed to being full invested, all being pressured to beat the S&P, all buying the stocks that the bears are unloading. So be prepared for a lot more confusing and erratic action. The bull is dying, but he's fighting mightily to stay alive. And all the while the bear is slowly gaining strength.

"Russell, in your opinion, what would 'seal it' for the bears? What would tell stubborn bulls that 'its all over'?"



Let's keep it simple: I show the D-J Industrials and Transports, each with their respective 200-day moving averages. Note that the Dow appears to be "churning" just below its 200-day MA (MA now stands at 8602). The Transports, however, are far below their own 200-day MA (MA now stands at 3251). So far in this bear market, the Transports have been the leader or the **bellwether** indicator. The Averages at this point appear to be in equilibrium, as if waiting for the next important impulse. In the meantime, the majority of NYSE stocks, as gauged by the advance-decline ratio (see page 2 chart), have rallied feebly and unconvincingly from their late-August lows.


July 14
5364
PRIMARY TREND
INDEX PTI)
89-Day Moving
Average (PTI)
July 8
10.52
5260
Oct.13
9.12
June 15
ADVANCE-DECLINE
RATIO (NYSE)
Whoa! The PTI as of Monday, Nov. 2 has pushed just ABOVE its 89-day moving average. Crossing back above the MA is either a rare whip-saw or a signal that the Dow means to possibly test its high (the Transports would probably NOT confirm). Meanwhile, the A-D ratio is improving, but still "miles" below its April 3 bull market high of 13.00.
Sept. 23
4.64
2.42
Oct. 8
JUNE
JULY
AUG
SEPT
OCT

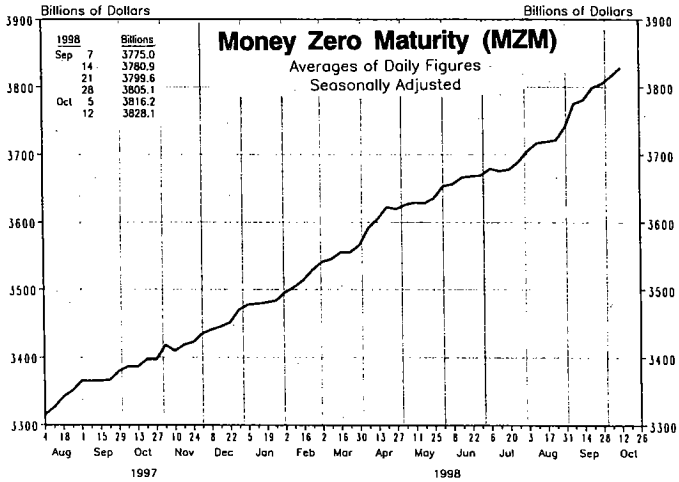
Answer: Both Averages breaking to new lows would, I think, nail the lid on the coffin. That would entail the Dow breaking below **7539.07** confirmed with a Transport closing below **2345.00.** If both Averages break to new lows, I think you'll see a wave of pessimism and fear and a general agreement that we are indeed in a primary bear market.

EXPLOSION: Nobody seems to be noticing it -- I'm talking about the **exploding money supply.** Here's the St. Louis' Fed latest chart of MZM, money of zero maturity or money that's immediately available for spending. On the latest four weeks, MZM has been expanding at the shocking rate of **19.2%.** In a world that's caught in a credit crunch, the Fed is giving us its remedy -- flood the economy (and maybe the globe) with dollars.

THE PICTURE: Last week on CNBC I heard a well-known brokerage house analyst reverse his bearish position and turn bullish -- this was a man who had announced loudly and publicly a few months ago that "this is a bear market." I sympathized with this fellow. People forget that every brokerage house is basically a selling organization. The fact is that the brokerage industry exists for the purpose of distributing securities to the public. So you can just imagine the pressure that is exerted on a house analyst, the pressure to be bullish, to remain bullish, or at worst, to not be too bearish, even during a major bear market.

Let me put it this way: a brokerage house bull who is wrong may lose much of his credibility, but he will be forgiven. But a bear who is wrong is never forgiven -- and in many cases he will be given his walking papers. In other words, if you are employed by a Wall Street firm and you turn bearish, you had damn well better be right.

For all the above reasons, I always take what I hear from Wall Street analysts with a grain (or many grains) of salt. I know that these good people have a job -- and that job is to sell securities. So actually, even during the worst bear market decline, analysts will talk about a few stocks that are resisting the downtrend, a group of stocks that are attractive, and as the decline continues and as stocks crumble, they will comment that stocks are becoming increasingly "cheaper," and that the market is moving ever-closer to a "buying range." You can't blame these analysts. They're doing their job, and they're in an industry whose basic



purpose is to sell securities. (Question: When is the last time you heard a Wall Street analyst issue an actual "sell" on a security?)

I ended the last Letter by saying that I've had an instinct about this bear market. My instinct is that this is going to be **a long, drawn-out, difficult bear market**. It's going to be the most manipulated bear market in history, and the reason is that modern governments truly believe that they can **control** the economic tides. And count on it, they're going to use that supposed control for all its worth.

Example: Look at the reaction, the euphoria, a few weeks ago when Fed chief Greenspan lowered interest rates for the second time in sixteen days. You could literally hear the cheering from millions of investors as the Dow surged 330 points on the first day. On hearing the news and in the face of the Dow surge, many analysts opined that it will be only a matter of time before the market attacks the July bull market highs. As far as the August 31 lows are concerned, analyst after analyst affirmed that the August lows represented THE bottom for the "correction."

I've said before that rallies in a bear market exist for two reasons: **(1)** They act like the **release valve** in a boiler in that they let off steam. In other words, when a bear market decline goes too far, when a decline has attracted too many shorts, when the pessimists believe they have the bull by the throat -- along comes a violent upward correction and the bearish steam escapes from the market boiler. **(2)** Rallies in a bear market serve the purpose of keeping traders and investors **optimistic and hoping.** Of course investors who are hoping tend to hold onto their stocks, and this is what the bear wants. As I've said so often, the bear's fondest dream is to move the market down while taking as many investors as possible down with him.

Extremes: Today's markets are composed of the greatest number of investors and traders in history. Roughly 45% of all US families have stocks or mutual funds. Today we are dealing with crowds and **crowd psychology**. As a result, market movements tend to go to extremes. Thus, we've seen the longest bull market in history, a 24-year bull market (1974 to 1998). Thus, we've seen the lowest yields and the highest price-earning ratios and the most extreme price-to-book ratios in Wall Street history (and these extremes are still with us). And most recently we've experienced one of the most violent breadth collapses in history. In other words, these are markets of extremes.

Change: One of the most difficult concepts to accept is that of change, particularly major change. I remember back in the late-1940s and early-1950s how worried investors were and how carefully, how safe, investors played it. Volume in those days was running about two to three million shares a day. The War had ended, but memories of 1929 and 1937 were still fresh in people's minds. Back in 1945 nobody in his wildest dreams was thinking in terms of a Dow at 1000. No, the big question in the 1940s and early '50s was "whether we would ever again see the Dow above its 1929 peak of 381." I remember well the day in

November of 1954 when the Dow (great balls of fire!) finally climbed above the 1929 high. To say that I was excited is putting it mildly. I stayed up all night in a state of high excitement and wonderment when the Dow finally hurdled that "impossible 1929 high."

November 1954 was probably the beginning of a true "new era." What was the new era? It was the beginning of hope, hope that the worst of the Depression was over, hope that the horrors of World War II were finally behind us. And hope that this, finally, was a real bull market. And good-bye to the old 1929 highs. We passed 'em.

It was around this time that we witnessed the beginning of the return of the public into the stock market. The latter part of the 1950s saw the public's interest in the stock market increase tremendously. From 1954 to the early 1960s public participation in the stock market surged. Old timers couldn't believe it. People who had lived through the Depression were flabbergasted. But sadly the great bull market ended in 1966 with the Dow in the 1000 area. From there the stock market entered into a series of spectacular rises and declines, ending in the ghastly bear market collapse of 1973-'74.

At the depths of late-1974, the seeds of the greatest bull market in history began to germinate. Pessimism was rampant, stocks were on the bargain table. People who had sold their shares were thanking their lucky stars that they were "out of the market." Here's how bad it was. I started accumulating stocks in December of '74 and January of '75. One stock that I wanted to buy was General Cinema, which was selling at a low of 10. On a whim I told my broker to put in an order for 500 GCN at 5. My broker said, "Look, Dick, the price is 10, you're putting in a crazy bid." I said, "Try it." Evidently some frightened investor put in an order in to "sell GCN at the market," and my bid was the **only** bid. I got the stock at 5. I mean, that was what it was like at the great bear market bottom of late-1974.

The new bull market started with stocks climbing all through the '70s and '80s. But it took until the 1990s to set off stock market mania. The bull market had started in 1974, but it took 16 years of climbing to generate real stock market mania.

Why a mania? Well, consider this: Starting in 1982 the market began to climb, and from 1982 to the present the Dow never closed below the low of a preceding year. Yes, **for 16 consecutive years the Dow never closed below the low of a preceding year's low**. Incredible. Fantastic. Nobody had ever seen a series like that before. That's because there never was a series like that. Even the crash of 1987 failed to take the Dow below the low of 1986 (the '86 low, by the way, was 1502.29).

Let's take it to the present. Question: What was the Dow low for last year? Answer: The 1997 Dow closing low was **6391.69,** roughly 25% below where the Dow is now. So think of it -- to break below last year's low, the Dow would have to decline over 2,000 points. Could it happen this year? Extremely doubtful, since time is rapidly running out on 1998.

What about this year's low being broken next year in 1999? The Dow closing low so far in 1998 was the August 31 closing of **7539.07.** So next year, in 1999, if the Dow was to close below 7539.07, the market would have done something it hasn't done since 1982, something it hasn't done in 17 years.

If we see a year in which the Dow closes below the low of a preceding year, I believe that would be highly significant. It would mean that the **bullish continuity would finally have been broken**. It would mean that something extraordinary had happened. If, next year, the Dow was to close below 7539.07 I believe investor sentiment would "mysteriously" change. I believe investor psychology would turn dead bearish. When that happens the bear market would then move into its second psychological and longest phase. The second phase is the phase that sees the mass exit of the public. It's the phase in which the stock market declines as it reflects deterioration in business and a steady decline in corporate profits. So keep that figure in your mind, better still, write it down, a Dow closing low for 1998 -- **7539.07.**

Irony: On October 27 it was announced that the "Consumer Confidence Index" had taken a huge drop, **the fourth successive monthly decline in this Index.** On this news, the long T-bond surged almost a point. Since the stock market has been trading off interest rates, the market ignored the consumer news and rose. Question: If consumer confidence totally collapses sending retail sales swooning and sending bonds much higher, will the stock market continue to love collapsing consumer confidence?

Remember, consumer buying constitutes two/thirds of GDP. It's obvious (at least to me) that the market is not taking the continuing slide of consumer confidence seriously. But what if sliding consumer confidence leads (surprise!) to a recession? That "unexpected" situation could set this high-priced market up for a crash.

INVESTMENT POSITION: The bear may be hiding but he's still here. In Letter 1262 I included a section entitled "Rich Man, Poor Man." In that section I noted that the rich man possesses a tremendous advantage in that he doesn't need the markets. The rich man has sufficient funds coming in so that if or when he doesn't like the market, he can just withdraw and sit on the sidelines. The rich man has no need to make money in the stock market or any other market.

In a market such as this one, the rich man can simply play it safe, put his money in T-bills and wait. "Russell, are you crazy," complains a subscriber, "T-bills are yielding less than 4%. I don't have the kind of money your rich man has, and I can't live on 4%."

And my answer is that the market doesn't give a damn how much money you have. But you better operate intelligently, which means operating "as if" you were rich, and that means staying out of a bear market and doing whatever you have to do to live within your means. Because, you see, the rich man has the brains to get out of a bear market, and you're not smarter than the rich man (remember, he didn't get rich by being stupid).

Sadly, your odds of coming away ahead in a bear market are about as good as your odds of coming away from a week in Las Vegas a winner. Sure, it can be done, but the odds of doing it are just not very good. Consider this, the last time the two Averages, Industrials and Transports, hit new highs together was in **early April**. That was the bull market top. **Seven months** have now elapsed without the two Averages going to new highs together. As far as the October rally, the most number of new highs was hit on October 20 at 48. Not too impressive for a big rally.

So here we are in a bear market, but with bull market sentiment still very much with us. The Russell advice -- don't try to beat the bear. Today, there are a few million people trying to do just that. Let 'em try, and good luck to them -- just don't join them.

Note: I haven't been recommending leaps or puts. Why -- way too expensive at this time. And you're fighting time.

RISK and STRESS: I'm not sure whether most people understand the concept of risk. Yet an understanding of risk is absolutely essential if you want to operate successfully in the markets (or in life, for that matter). What is risk? **Risk is the appraisal of the possibility of failure in any venture,** plus a realization of the penalty involved if indeed you do fail.

There are many nuances in the risk concept. For instance, in order to make real money in the market you must assume a fairly large position in a given item. Let's take the example of an initial public offering in a stock which comes out at the offering price of 10. How much do you have to buy in order to make real money? What if the company goes belly up? How much of a loss do you take if the stock falls apart, dropping say 50% or 75%?

Against that, how about putting the same money into a Treasury bond? How about a "safe" common stock like Duke Power? What are the penalties in each case if you are wrong on the trend? What are the odds of Duke Power dropping substantially? On the other hand, how much chance is there that Duke Power can rise say 25%?

Finally, how much of a loss are you willing to take in any transaction if you are wrong? I spent many years back in the '40s and early '50s in the New York textile business. Believe me that was one tough business, but for me it was also a school for learning. I worked for a very smart boss in those days, and one day he took me aside and told me, "Russell, I never waste time thinking about what can go right. You know what I worry about? I worry about what can go wrong. The right things take care of themselves, it's the things that go wrong that can kill you." I never forgot those wise words.

All of which brings me to the subject of stress. There's a big difference between stress and tension. Everybody is subject to some tension, and there's nothing wrong with that. All life is subject to tension, without it we wouldn't be alive.

But stress implies conflict. Stress means that you are torn between conflicting emotions. I assume a huge position in a stock, and I feel stressed. Why? Because if I'm wrong I can take a huge hit, much more than I want to and more than I can really manage. So I'm stressed. I know in my gut that I took too large a position, much larger than I should have. I got greedy. I can't sleep nights as I go over and over the meaning of the risk I've assumed. On the one side, I can make a killing if I'm right. But on the other side, I can't afford the loss if I'm wrong.

Result: Stress. And the Russell opinion -- the wear and tear on my psyche just isn't worth it. I'm under too much stress. That trade is on my mind all day and most of the nights. I curse my decision: it wasn't worth the stress.

I think stress takes a toll on a person's health. Stress is a killer. Stress wears you out. Stress lowers your immune system. Personally, I've learned to say "No" to situations which I know will bring on stress. I make a real effort to avoid stressful situations. There are certain situations where you can't avoid stress. Combat during war is one. But in the vast majority of cases, you can avoid stress. Appraise the risk entailed in any endeavor, appraise the risk correctly -- and you will avoid a good deal of stress, plus potential losses.

NOTES & QUOTES: Could I be doing something right? September was the biggest month for subscriptions I've had in the 40 years since I started *Dow Theory Letters*. So greetings to all you new subscribers. And for regular subscribers, many thanks for your subscription renewals (renewals here are running at above 85%, which I believe is the highest in the advisory industry) . . . I looked at my last Letter and it does seem to me that the print is too darn small. The choice, bigger print and less Russell or smaller print and more Russell. I always have more to say than I have room for, even with this small print, so I guess the small print will stay. Sorry . . . I've also received more letters, most asking questions, than ever before. Forgive me, but if I answered them all I wouldn't have the time or energy to do anything else. So I've just given up answering the letters; I just can't do it. But as for comments, observations, and info, keep 'em coming. They're a great help.

Being Right: In many businesses, you can have a great year and you can sit back and feel good about it -- which is great. Not in my business. In this business you can never feel good about it, because you can never know if you are right. Yeah, you can be right for a few weeks or a month or so, but there's always that period ahead that you have to worry about. Or you can be right on the big picture but dead wrong on the next three or four months. So in the advisory business any time you start thinking you're a guru or a genius, forget it, that's just about the time you're going to look like Wall Street's number one numbskull. I used to stay up nights worrying about whether I was giving my subscribers the right advice. Then one day I had a flash. I would simply tell my subscribers that I'm doing the best I can, and that's all I can do. That realization took a lot of pressure off me. Today I continue to do the best I can, and honest, I can't do any better. But a guru, Mr. Infallible, a genius, forget it -- if that's what you're looking for, you're reading the wrong Letter. All I offer is my best.

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Simple: The critical question for the market now boils down to this: Are we going to experience a mild downturn next year, a downturn that the stock market can look past? Or are we going to experience a real recession, one that is going to hit corporate earnings hard, hard, hard? So far, and I emphasize just so far, the stock market appears to be choosing the mild downturn.

* *

Earnings: Everybody's got a different idea of what **S&P earnings** will be next year. At Dean Witter the guessing is around $50. But Ed Hyman, Wall Street's favorite analyst, disagrees. The latest Hyman estimate is $43 for the seasonally adjusted annual rate, which means earnings heading down. The estimates for S&P 500 earnings are some of the most watched figures on Wall Street, since these estimates tell us whether analysts think stocks in general are priced too low, too high or just right. The S&P price/earnings ratio for the past 12 months is 27.5, and if earnings continue to decline with stocks rising, the P/E ratio will be in "economic dreamland." Normal P/Es with the S&P producing near-record earnings (as now) would be about 12, less than half of today's sky-high P/Es.

Meanwhile, *Business Week* (Nov. 2) headlines its story, "Ouch, It's Beginning to Hurt -- US third-quarter earnings are off 7% from last year's level." The article continues, "Profits are down 7% from a year ago on an anemic 2% sales increase. Worse, the weakness that emerged in the second quarter has now spread beyond manufacturing to service companies -- whose earnings had risen 20% in the second quarter, only to drop 23% in the third."

On top of that, **yield spreads** between safe 10-year Treasury notes and speculative 10-year high-yield bonds are near the highest in history, roughly 275 points. Thus, the bond market continues to pay a high price to avoid risk, a bad sign for the economy. In the meantime, *Barron's* (Oct. 26) included an interview entitled, "Prozac, Please," in which David Levy of the prestigious *Levy Economics Institute of Bard College* states, "I suspect that fourth quarter will be worse still. We see some very negative numbers, double digit declines, possibly as much as 30% in some periods. In terms of reported earnings, which tend to be more erratic, we will see year-over-year declines through most of next year -- and some could be very steep. It could look ugly. I think this is going to be a nasty recession because of the international situation and the unwinding of the bubble in consumer spending . . . I doubt that further rate cuts at this point can offset the negative earnings and other problems that are going to come along . . . It may be, as some people say, that in

the long run -- 20 years, say -- it won't matter if you buy today. But I suspect that most people will be a lot more comfortable over the next two years or so if they're not heavily exposed to what will be a high-risk stock market."

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With the euro coming into being in January 1999 there's a battle going on between London, which is now Europe's financial center and Frankfurt, which will be the headquarters for the new euro. Britain has elected to stay out of the euro universe, at least for now. But count on it -- Germany will opt to become the new financial center of Europe, and its ace in the hole will be the fact that euro activity and control will be centered in Frankfurt.

The birth of the euro will mark an amazing and unprecedented experiment in which 11 nations will give up their own currencies in favor of one new, untested currency. Unlike the 50 US states, the Europeans are 11 very different nations with different languages, different customs, different economies. So will the euro work? Obviously no one knows, but we do know this -- translating all these different currencies into the new currency will represent one of the most difficult financial exercises in history. Already, however, we have one hint as to the effectiveness of the euro -- the synthetic euro has been rallying strongly against the weakening dollar. And it's certain that Europe's central banks will be **selling their dollar reserves and at the same time they will be building euro reserves.** Europe's dream -- a European currency that can and will compete with the dollar.

A serious consideration: The US, with its dollar as the world's reserve currency, possesses one huge advantage. The US can run up huge debts from other nations (trade deficits, current account deficits) and then to pay off these debts Uncle Sam merely has to print the money. In other words, the US takes in goods and merchandise from around the world and pays off with -- its own manufactured paper. This process has particularly galled Europe, and it's another reason why they want their own money.

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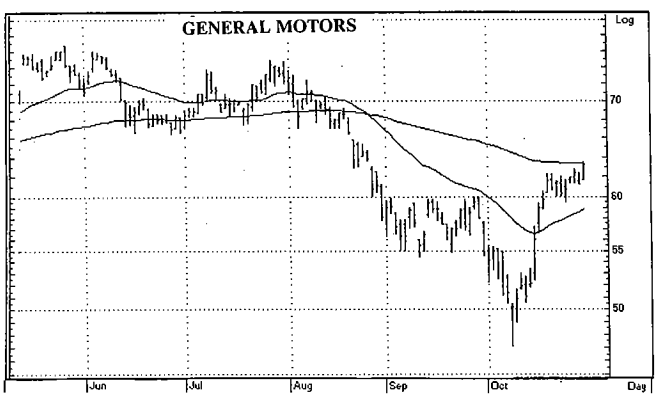
Wall Street lore (I think Robert Stovall came up with this) has it that if six months go by without a new high in **GM,** it's a bearish indication. GM hit its bull market high of 76 22/32nds on May 26. If, by November 26, GM has not advanced to a new high, the GM "signal" will have turned bearish. As this is written, GM is far below its May 26 high. I'll get a major sell signal for GM (based on my moving average method) if GM drops below 58.



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America's capital of idiocy is Las Vegas, a city that produces nothing while extracting billions of dollars from dopey or misguided gamblers. Vegas keeps adding more and more hotel rooms, until today it finally appears there are just too many rooms. Room occupancy rates are now down to 86% from 90% a few years ago -- this in a city that operates on the thesis of full capacity. Two weeks ago the $1.6 billion Bellagio opened, a hotel boasting a new level of luxury replete with an eight-acre lake and 1,000 fountains, the lake lined with "Tuscan" villas. On top of all that, Bellagio boasts a $300 million art collection. The Bellagio has evidently set off a boom in construction in Vegas that will add 20,000 rooms over the next two years at a price tag of $7 billion. Coming up: Mandalay Bay with 3,700 rooms; The Venetian with 3,036 rooms; Paris with 2,900 rooms. Madness? I tend to think so. By the way, Vegas has been losing its big Asian rollers.

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Internet: I've long been skeptical of America Online and its slow access to the Net. Now ultrafast "broadband" systems threaten AOL with its 13 million subscribers. Using cable modems or the digital phone lines that some telephone companies are starting to offer, online access is simple and almost instantaneous. So it should slowly dawn on people -- "Who needs America Online?" AOL hit a high of 129 on July 21, then traced out what would appear to be a "double top" on Sept. 24 and Oct. 26. Earnings are up, but I think the stock is in the process of topping.

* *

How will the great Microsoft trial come out? **(1)** MSFT wins all important points: If this happens MSFT will go on doing its thing, being a fierce competitor and gobbling up the competition. **(2)** A split decision: This would still favor MSFT, since nothing would be solved, and MSFT's competitors would not have the money to wage another costly battle. **(3)** Justice wins on all important points: Here there is a chance that MSFT would be broken up into three divisions, one company that sells operating systems, one that creates different kinds of software, and one that sells browsers and Internet products. **Best Russell guess:** A split decision, but Justice is in a power struggle with MSFT, and this whole thing will drag on and on with Justice hanging on like the proverbial bull dog. Remember, when you fight the government you're fighting hundreds of ambitious lawyers and untold millions of dollars.

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As people get older, they supposedly have learned something, and therefore, the theory goes, they become "smarter." The following are some suggestions taken from famed author Kurt Vonnegut's commencement speech at MIT: "Ladies and gentlemen of the class of '97, wear sunscreen. If I could offer you only one tip for the future, sunscreen would be it. Enjoy the power and beauty of your youth -- trust me, in 20 years you'll look back at photos of yourself and recall how fabulous you looked. The real troubles in your life are apt to be things that never crossed your worried mind. Do one thing every day that scares you. Don't be reckless with other people's hearts, don't put up with people who are reckless with yours. Floss. Remember the compliments you receive, forget the insults -- if you succeed in this, tell me how. Stretch. Don't feel guilty if you don't know what to do with your life; the most interesting people I know didn't know at 22 what they wanted to do with their lives. Some of the most interesting 40-year olds I know still don't. Get plenty of calcium; be kind to your knees, you'll miss them when they're gone. Maybe you'll marry, maybe you won't. Maybe you'll divorce at 40, maybe you'll dance the funky chicken at your 75th wedding anniversary. Whatever you do, don't congratulate yourself too much, or berate yourself either. Your choices are half chance, so are everybody else's. Dance, even if you have nowhere to do it but in your living room. Get to know your parents, you never know when they'll be gone for good. Live in NYC once, but leave it before it makes you hard. Live in Northern California once, but leave it before it makes you soft. Travel. Don't mess with your hair -- by the time you're 40, it will look 85. Be careful about whose advice you buy -- but trust me on the sunscreen." **Russell Comment:** All good advice, but rather than use sunscreen I just stay out of the sun.

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I just read a fascinating article in *Scientific American* magazine. The article states that all organisms adjust to their environment (if they can't, they disappear). Man also adjusts, but modern man still has the biological body system of the primitive man of say 25,000 years ago. Primitive man didn't have access to the fat and assorted junk that we eat today. So with basically the

same body as the man of 25,000 years ago, we, today, are taking in fat, soda, liquor, processed food, lots of red meat, junk food. It's no wonder, then, that modern man contracts so many diseases including cancer, heart attacks, strokes, etc. We're eating a diet that our bodies have not adjusted to and are not ready for. The whole thesis makes sense to me.

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I've often wondered why incumbent politicians are so obsessed, so frantic, to be re-elected. Is it that the jobs are so fabulous? Are the perks irresistible? Is it the sense of power? So the other day I asked my wife Faye the question. "Why, why will they lie, scheme, spend millions, just to get re-elected?" Faye's answer was the same as mine. "Because most of them don't know how to do anything else."

LATE NOTES, THOUGHTS: It's obvious that a large number of investors believe that the worst is over, and that either a new bull market has started or the "old bull market" has resumed. This is the kind of sentiment I foresaw, and in almost every Letter since the Dow Theory bear signal of August 4, I've warned this was fated to be a very difficult, deceptive and **extended** bear market.

For this reason I have never recommended short sales or even the buying of puts or leaps. When you speculate for the downside, you are always **fighting time**. Even when you sell a stock short you are fighting time, since you must pay out dividends on the stock you have shorted. So, for the sake of argument, if you short a stock and the stock moves sideways for a number of months, you will be out commissions plus dividends while hoping day after day for an event that never seems to happen, the event being news that the stock that you've shorted has collapsed.

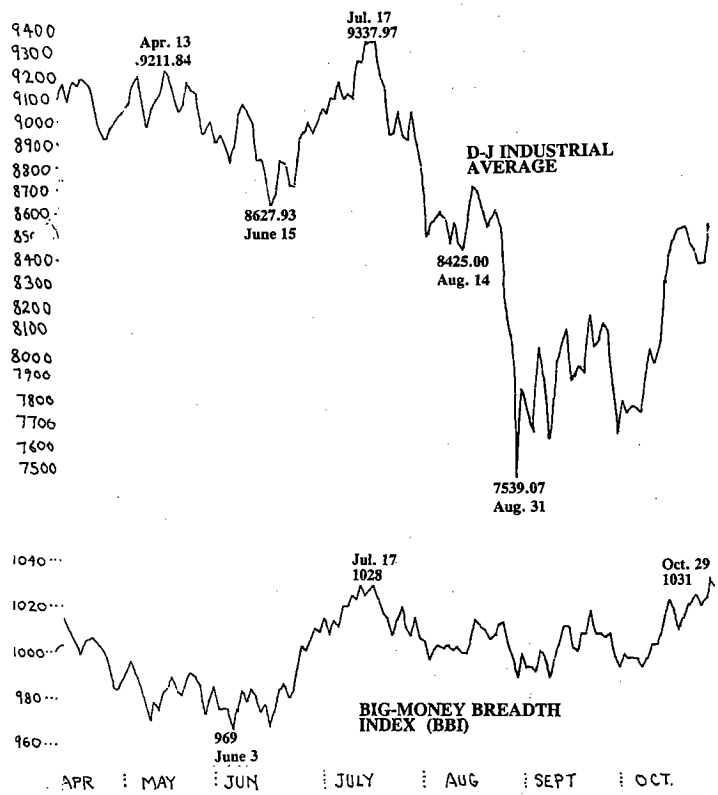
In writing about this market, one period that has been on my mind was the maddening, back and forth series that started at the 1966 high and carried through to a confusing 1972 -- prior to the conclusion which was the catastrophic bear market collapse of 1973 and 1974. I sincerely hope we don't have to go through those kinds of market shenanigans before this bear market comes to its final conclusion.

I also warned that the Fed and the government would fight the bear "tooth and nail." And, of course, that's exactly what is happening. Brazil appears to be the next bail-out of the week, and very probably the next "problem" will be China, which is now suffering from massive unemployment and a weakening of its yuan in the tell-tale black market.

Again I warn subscribers against following the buy-buy advice that is now pouring out from a thousand sources from brokerage house reports to CNBC to the Internet to your local newspaper. The "cult of equities" is now thoroughly ingrained in the American psyche, and the idea of buying a collection of stocks and a year or so from now seeing those stocks lower seems almost heretical.

On the other hand if -- a few decades ago -- I had advised buying an assortment of stocks with average P/E ratios of 27 and yields averaging 1.5%, I would have been considered to be out of my mind. Yet, that's exactly what today's buyers are doing. So bullishness continues to be the order of the day, and buyers continue to load up on severely overpriced stocks.

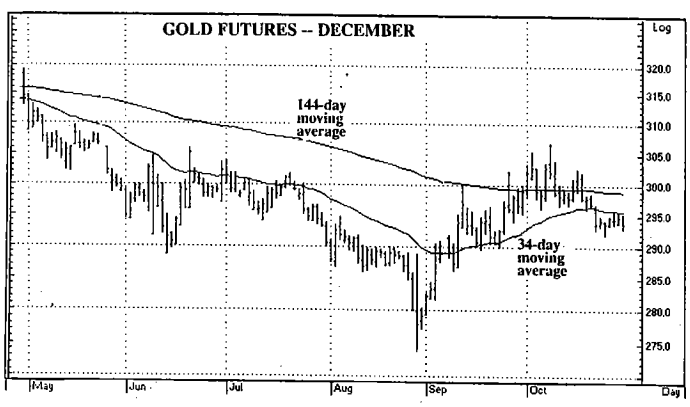
Big Money: On October 29 my **Big-Money Breadth Index (BBI)** advanced to a new high for the year. The BBI is an advance-decline line of the 10 largest-cap stocks in the S&P 500. This is important action. The BBI is telling us that the big stocks have been the strength of the market ever since the BBI low of June 3. Cutting through all the baloney, the BBI is showing us why the Dow and the S&P never collapsed in the way that the smaller cap stocks did. True, the big cap stocks backed off around 20% (July to September), but they never really fell apart



as did so many smaller issues. Conclusion: You're just not going to have an all-out bear market smash as per 1973-74 until the big stocks give up the ghost.

GOLD: Remember that famous Russell poem? It runs, "Gold, gold, you're making me old." I guess it's time to resurrect that poem again. As you can see on the chart, the gold rally did not have enough steam or lasting power to take the 34-day moving average for the December gold futures above the 144-day MA. That was not a good sign. Then on October 22 gold fell below its 34-day MA again -- that was a poor sign and normally a "sell signal" on my method of reading the moving averages.

So what do we have? We have gold still holding well above its extreme August 2 low of 273.8 -- and that's a plus. What about the surging US money supply? Why doesn't that move gold up? Obviously, gold knows all about the rising money supply, but consider this: the commodity indices are holding just above their August lows, oil is still cheap at around 14 bucks a barrel, retailers tell us that unless merchandise is on "sale," it doesn't move. Competition in all areas remains fierce. It could be that there is so much over-production in the world economy that it would take even more money-creation to move prices (and gold) higher. In the meantime, the gold stocks, having surged mightily during September, are tending to hold their gains. And that's a big plus for the gold shares.



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